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No. 71-308

In the Supreme Court of the United States

OCTOBER TERM, 1971

UNITED STATES OF AMERICA, PETITIONER

v.

MARIAN A. BYRUM, EXECUTRIX UNDER THE LAST WILL AND TESTAMENT OF MILLIKEN C. BYRUM, DECEASED

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The opinion and order of the district court (R. 33-39)[1] are reported at 311 F. Supp 892. The majority opinion of the court of appeals and the dissenting opinion of Chief Judge Phillips (R. 41-50) are reported at 440 F. 2d 949.

JURISDICTION

The judgment of the court of appeals was entered on April 8, 1971 (R. 51). By order dated June 28, 1971, Mr. Justice Stewart extended the time for filing

[1] "R." references are to the separately bound record appendix.

a petition for a writ of certiorari to and including September 4, 1971. The petition was filed on August 30, 1971, and certiorari was granted on November 9, 1971 (R. 52). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

The decedent transferred to an irrevocable trust stock in three corporations which he controlled, and he retained, for his lifetime, the right to vote the transferred stock and voting control of the corporations, and also reserved the power to prevent the trustee from selling or otherwise disposing of the stock.

The question presented is whether the value of the stock transferred is includible in the decedent's gross estate because, within the meaning of Section 2036(a) of the Internal Revenue Code of 1954, he retained for his lifetime the right to designate the persons who would enjoy the income from the stock or the right to continued enjoyment of the stock.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 2036 [as amended by Sec. 18(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 1052]. TRANSFERS WITH RETAINED LIFE ESTATE.

(a) *General Rule.*—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's

worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

* * * * *

STATEMENT

Decedent, Milliken C. Byrum, owned controlling common stock interests in three closely held corporations whose stock was at no time listed on any stock exchange. On December 9, 1958, he created an irrevocable trust to which from time to time thereafter he transferred shares of such stock. The income beneficiaries of the trust were his children; the trust terms provided that the decedent, for his lifetime, would retain (1) the right to vote all unlisted stocks, and (2) the right to prevent the trustee from selling or otherwise disposing of any trust assets. Subject to these and other powers retained by decedent, the trustee (a bank) was given the power, until decedent's youngest child reached age 21, to distribute trust income and principal to the beneficiaries in its (R. 14) "absolute and sole discretion * * * with due regard to their individual needs for education, care, maintenance and support * * *," and with no duty to equalize distri-

butions among the children.[2] Thereafter, separate trusts were to be established for each living child and for the surviving issue of any deceased child. Each child's separate trust was to terminate when that child reached age 35. (R. 10–11, 14–15, 33–35, 42–44.)

Decedent died on September 5, 1964. At that time he and the trust (by virtue of his transfers) held common stock in the three corporations in the following proportions:

	Percentage Owned by Decedent	Percentage Owned by Trust	Total Percentage Owned by Decedent and Trust
Byrum Lithographing Co., Inc.	59	12	71
Graphic Realty, Inc.	35	48	83
Bychrome Co.	42	46	88

The transfers of stock in trust, subject to decedent's assured voting power, thus had no effect on decedent's lifetime control of the corporations. (R. 44, 46.)

Section 2036(a) of the Internal Revenue Code of 1954 (*supra*, pp. 2–3) requires the inclusion in the gross estate of a decedent of the value of any property he has transferred by *inter vivos* gift, if he retained for his lifetime "(1) the * * * enjoyment of * * * the property" transferred, or "(2) the right, either alone or in conjunction with any person, to designate the persons who shall * * * enjoy * * * the income therefrom." Following decedent's death, the Commissioner determined that the transferred stock was includible in his gross estate under Section 2036(a)(2), because, by reason of his retained power to control

[2] Decedent also reserved the rights to direct trust investments and to remove the trustee and designate another corporate trustee as successor (R. 11, 14, 16–17, 34, 44).

corporate dividend policy, he had the right to regulate the flow of income to the trust, and thereby to postpone the beneficial enjoyment of the income from the stock until after his death. The Commissioner also determined that the shares were includible under Section 2036(a)(1), because, by reason of his retained power of voting control over each corporation, he had the right to continue to benefit economically from the transferred shares for his lifetime.

In the refund action which followed, on cross motions for summary judgment, the district court granted respondent's motion (R. 33–39). The government appealed, and a divided court of appeals affirmed, Chief Judge Phillips dissenting (R. 41–50). He would have held the transferred stock includible under both subsections of Section 2036(a).

SUMMARY OF ARGUMENT

I

By retaining voting control of the corporations whose stock he transferred in trust, decedent was in a position to dictate corporate dividend policy. Through exercise of that retained power, he could increase or decrease corporate dividends (or stop them entirely), and thereby shift or defer the beneficial enjoyment of trust income. This retained power is tantamount to the power to accumulate income, which this Court has recognized constitutes the power to designate the persons who shall enjoy income from transferred property under Section 2036(a)(2). See *United States v. O'Malley*, 383 U. S. 627, 631.

The court of appeals' majority erred in concluding that decedent had power only to elect directors, but not to control dividend policy. As this Court has pointed out, a controlling stockholder in a close corporation can change the composition of his corporation's board virtually at will, and thereby assure that the directors vote in accordance with his wishes. See *Commissioner* v. *Sunnen*, 333 U.S. 591, 608.

Nor was the majority below correct in its holding that decedent's power to shift the beneficial enjoyment of the income was significantly limited by the fiduciary obligation imposed upon directors to act reasonably and in good faith in determining dividend policy. The directors' discretion in this regard is broad, and only narrow restrictions are imposed upon the exercise of that discretion. Except in extreme circumstances, therefore, the directors would be free to choose between two entirely appropriate alternatives—paying dividends and not paying dividends—and their decision would be final. Any limitation on decedent's power to determine dividend policy thus falls far short of establishing the kind of "ascertainable standard" which has been held to place a grantor's power to shift enjoyment beyond his own control.

A grantor who retains, as trustee, only the power to manage trust property is not in a position to regulate the flow of income to trust beneficiaries. Although he has substantial discretion with regard to investment policy, he also has a duty (assuming the trust instrument does not grant him additional powers) to

treat current beneficiaries and remaindermen impartially. Decedent, on the other hand, had no such duty, and through his retained power over corporate dividend policy, coupled with his veto power over sales of the stock in question, could regulate the flow of income to the trust. The court of appeals incorrectly held that decedent's power was no different in substance from a grantor-trustee's power merely to manage trust property.

II

By retaining voting control of the corporations, and by assuring himself of that control for his lifetime by reserving the right to veto any sale of corporate stock, decedent retained the most important economic benefits incident to the controlling stock interest in a close corporation. These included the rights to continued employment with the corporations and to set his own salary and other remuneration.

It matters not that the retention of any one power by decedent would not have caused the value of the transferred stock to be included in his gross estate. In determining whether decedent retained the "enjoyment" of that stock within the meaning of Section 2036(a)(1), the various powers retained are to be considered in the aggregate and in the light of the fact that decedent remained the controlling stockholder. It likewise is of no moment that decedent did not retain every benefit associated with the stock interest transferred. The retention of any substantial economic benefits is sufficient under the decisions of

this Court to invoke the enjoyment provision of Section 2036(a)(1). See, *e.g., Commissioner* v. *Estate of Church,* 335 U.S. 632, 645.

ARGUMENT

INTRODUCTION

The purpose and method of the federal estate tax are to lay a tax upon the passage of property at death. Accordingly, in the ordinary case, the value of the property held by the decedent at his death is the subject of the tax. But to effectuate this basic policy, it was long ago found necessary [3] to include in the decedent's gross estate for federal estate tax purposes property which was the subject of a gratuitous, incomplete transfer made during his lifetime. In general, Congress has required that in order to escape the estate tax, an *inter vivos* transfer must be absolute—the decedent may retain no substantial rights in the transferred property. See Sections 2036–2040 of the Internal Revenue Code of 1954. And this is particularly true with respect to the "enjoyment" provisions of Sections 2036, 2037 and 2038, all of which are derived from Section 811 of the 1939 Code, and have been treated extensively by this Court.

Section 2036(a) deals with transferred property subject to the grantor's retained power (1) to continue to enjoy the transferred property, or (2) either

[3] Cf. the reference of Cardozo, J., as long ago as 1933, to "the Government's endeavors to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens." *Burnet* v. *Wells*, 289 U.S. 670, 676.

alone, or in conjunction with any person, to designate the persons who shall enjoy the income therefrom. The contested issue in this case is whether decedent's transfer in trust of stock in corporations over which he exercised voting control effectively removed that stock from his gross estate, when he retained the power to vote the stock for his lifetime, and the power to prevent the trustee from selling the stock. Our position is that principles established by this Court in a series of decisions spanning the last three decades compel the conclusion that the value of the stock is includible in the decedent's gross estate under both Section 2036(a)(1) and Section 2036(a)(2). Of course, reversal of the judgment below would be required if the Court accepts either of our arguments.

I. DECEDENT'S RETENTION FOR HIS LIFETIME OF EFFECTIVE CONTROL OVER CORPORATE DIVIDEND POLICY GAVE HIM THE POWER TO "DESIGNATE" THE PERSONS WHO WOULD ENJOY THE INCOME FROM THE TRANSFERRED STOCK WITHIN THE MEANING OF SECTION 2036(a)(2)

A. DECEDENT HAD THE POWER TO SHIFT THE BENEFICIAL ENJOYMENT OF THE INCOME FROM THE TRANSFERRED STOCK

A grantor who transfers property in trust, and who retains for his lifetime the power either to distribute or accumulate trust income may, by exercising the latter power, deny current trust beneficiaries the privilege of immediate enjoyment of the income, and condition their eventual enjoyment upon surviving the grantor. Such a power therefore constitutes a power to "designate" who shall enjoy the income from the trans-

ferred property within the meaning of Section 2036 (a)(2), and its retention by a grantor requires inclusion of the value of the transferred property in his gross estate. See *United States* v. *O'Malley,* 383 U.S. U.S. 627, 631.[4] As this Court explained in the *O'Malley* case, only this conclusion comports with "the legislative policy of subjecting to tax all property which has been the subject of an incomplete *inter vivos* transfer."

Decedent's transfers here were no more complete than those involved in *O'Malley.* Of the bundle of rights which inhered in his ownership of the shares, he retained important elements which gave him continuing voting control of the corporations. He thus was assured for his lifetime of effective power to determine all aspects of corporate policy, including corporate dividend policy. Because decedent retained this power, no income from the transferred stock could become available for distribution by the trustee during decedent's lifetime unless decedent first approved the payment of dividends to the trustee.

The majority below held nevertheless that decedent's retained power fell short of the power to "designate", as that term was construed in *O'Malley.* It reasoned (R. 45) that decedent did not retain the

[4] See also *Commissioner* v. *Estate of Holmes*, 326 U.S. 480, 487; *Lober* v. *United States*, 346 U.S. 335; *Joy* v. *United States*, 404 F. 2d 419 (C.A. 6); *Ritter* v. *United States*, 297 F. Supp. 1259 (S.D. W. Va.); *Estate of Rott* v. *United States*, 321 F. Supp. 654 (E.D. Mo.).

right to control dividend policy, but "only controlled who could serve as directors of the corporation. These individual directors", the majority continued, "would then be under a fiduciary obligation to exercise sound business judgment in declaring dividends and could not act in bad faith to the injury of the beneficial owners of the stock." The majority concluded that "[t]his obligation is governed by an ascertainable standard and is analogous to the situation that exists in cases where the grantor retains broad managerial control of a trust * * * [citations omitted] and does not result in making these assets includable in the grantor's estate." [5]

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[5] *Estate of King* v. *Commissioner*, 37 T.C. 973, upon which the majority below relied (R. 45), is not in point. The Tax Court there specifically found as a fact (37 T.C. at 974) that the securities in question "were at no time significant from the point of view of control of the particular companies involved." *Yeazel* v. *Coyle*, 68-1 U.S.T.C., par. 12,524 (N.D. Ill.), also cited below (R. 45), is contrary to our position. In that case, however, unlike this one, the district court acknowledged that the grantor, as controlling stockholder, could have prevented the payment of a dividend and thereby regulated the flow of income to the trust. Having done so, it inexplicably concluded, despite this Court's opinion in *O'Malley*, *supra*, that—

> [a]lthough * * * [the settlor] could have prevented the corporation from paying a dividend, that action would not have deprived the beneficiaries of the possession or enjoyment of either the property or income because the retained earnings of the company would increase, thus making the beneficiaries' stock more valuable * * *.

This observation misses the point that it is the power to grant or withhold immediate enjoyment that is critical in cases of this character. See *Lober* v. *United States*, 346 U.S. 335, 337.

B. THE FACT THAT DECEDENT'S POWER WAS EXERCISABLE THROUGH THE BOARDS OF DIRECTORS DOES NOT RENDER SECTION 2036(a)(2) INAPPLICABLE

1. Decedent had effective control over corporate dividend policy

The analysis of the majority below is erroneous in its failure to acknowledge the obvious power of a controlling stockholder to determine corporate policy. This Court, on the other hand, recognized the practical significance of such power nearly a quarter-century ago in *Commissioner* v. *Sunnen,* 333 U.S. 591,[6] and rejected the very arguments which respondent pressed successfully in the court of appeals.

The taxpayer in *Sunnen* was an 89 percent stockholder, a director, and the president of a corporation. He gave the corporation nonexclusive manufacturing licenses under patents which he owned individually, in return for its agreement to pay him royalties. The corporation was not bound to manufacture any minimum number of the patented articles, and either party could cancel the contract without liability upon giving the required notice. The taxpayer assigned his interest in the royalty agreements to his wife, and she reported the royalties as her own income. The Commissioner determined that the royalties constituted income to the taxpayer because, as controlling

[6] See also *Morgan* v. *Commissioner*, 42 T.C. 1080, 1087, affirmed *per curiam*, 353 F. 2d 209 (C.A. 4), certiorari denied, 384 U.S. 918; cf. *Reeves' Estate* v. *Commissioner*, 8 T.C.M. 131, affirmed, 180 F. 2d 829 (C.A. 2), certiorari denied, 340 U.S. 813; O'Neal & Derwin, *Expulsion or Oppression of Business Associates*, pp. 6, 46–47 (1st ed., 1961).

stockholder, he retained a substantial interest in the royalty contracts, and had the power to fix the amount of royalties that would be paid to his wife and the time when the royalties would be paid.

The taxpayer argued in response that the corporation's right to cancel without liability could not be attributed to him, since he was only one of five directors, and a majority vote was necessary for director action. To this the Court replied, in language which we believe to be directly applicable to the case at bar, that (333 U.S. at 608) the corporation's power to cancel "gave the taxpayer, in his dominant position in the corporation, power to procure the cancellation of the contracts in their entirety. That power was nonetheless substantial because the taxpayer had but one of the three directors' votes necessary to sanction such action by the corporation. Should a majority of the directors prove unamenable to his desires, the frustration would last no longer than the date of the next annual election of directors by the stockholders, an election which the taxpayer could control by reason of his extensive stock holdings."

Here, as in *Sunnen,* the controlling stockholder was in a position to dictate corporate policy to the board. And it is no answer to say that *Sunnen,* an income tax case, is inapposite to the situation at hand. For present purposes, *Sunnen* is squarely in point, for this Court has consistently held that substance and reality, rather than form, are to govern in the application of Section 2036, of the related provisions of Sections 2037 and 2038, and of their predecessors under

prior law. See *Helvering* v. *Hallock,* 309 U.S. 106, 114, 116–118; *Commissioner* v. *Estate of Church,* 335 U.S. 632, 643–646; see also *United States* v. *Estate of Grace,* 395 U.S. 316, 321. The notion that decedent was without power to determine whether and when dividends would be paid blinks reality.

It is likewise no defense to the application of Section 2036(a)(2) that decedent's control over dividend policy was exercisable through the boards of directors of the corporations, rather than by him individually. That provision is not confined to situations in which the grantor alone has the power to designate. It applies, by its terms, whether his power is exercisable "alone or in conjunction with any person." Indeed, in the *O'Malley* case itself, the grantor was one of three trustees (383 U.S. at 629).

2. The directors' fiduciary obligation to act reasonably and in good faith in determining dividend policy did not significantly limit decedent's power to shift beneficial enjoyment

The taxpayer in *Sunnen* also argued that since he owed a fiduciary duty to the corporation, he could not cancel the contracts if that would amount to a fraud on the corporation. The Court first pointed out (333 U.S. at 609) that there might be valid business reasons for cancellation that would not constitute fraud. "All that we are concerned with here", the Court explained, "is the power to procure cancellation, not with the possibility that such power might be abused."

The same reasoning is applicable in the instant case. There are, to be sure, extreme circumstances that could be imagined in which the decedent's decisions with re-

spect to dividend policy could constitute an abuse of discretion. But, except in extreme situations, the directors' determination with respect to the payment or nonpayment of dividends could not be questioned. The directors' fiduciary obligation with regard to dividend policy requires only that they act honestly and reasonably (Bogert, *Trusts and Trustees,* § 841 (2d ed., 1962)); when accumulated earnings are reinvested in the business or are retained for any number of other valid reasons, the judgment of the directors ordinarily will be regarded by the courts as conclusive (11 Fletcher, *Cyclopedia Corporations,* § 5325 (Perm. ed., 1971)).

The vice, then, of decedent's retention of power to control dividend policy is not that that power might be abused. Rather, it is, as it was in *Sunnen,* that the power would be exercised, fully consistently with the directors' fiduciary obligation, in favor of the nonpayment of dividends, with the inevitable consequence that beneficial enjoyment of the income would be postponed until after decedent's death. See *Rollins* v. *Helvering,* 92 F. 2d 390, 395 (C.A. 8), certiorari denied, 302 U.S. 763.

Under these circumstances, there is no basis for the holding below that the fiduciary duty imposed on corporate directors with respect to the declaration of dividends creates an ascertainable standard which a court of equity would apply to compel the directors to declare or refrain from declaring dividends. On the contrary, as we have seen, the discretion invested in directors regarding dividend policy is such that a

court of equity would intervene only upon a showing of unreasonableness or bad faith. The fiduciary obligation did not, therefore, provide a significant limitation on decedent's power to shift the beneficial enjoyment of the income. Cf. *Ithaca Trust Co.* v. *United States,* 279 U.S. 151; *Old Colony Trust Co.* v. *United States,* 423 F. 2d 601, 604 (C.A. 1). After the transfers here in question, as before, decedent was largely free to determine whether all, some, or none of the corporations' earnings would be distributed as dividends or retained in the businesses.[7]

Contrary to the apparent understanding of the majority below, it is not enough to establish an ascertainable standard that a court of equity would intervene upon a showing of a fiduciary's unreasonableness or

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[7] The instant case was decided in the district court on cross motions for summary judgment. The record does not indicate the state in which any of the corporations in question were incorporated. However, respondent represented below and in her brief in opposition (pp. 3–4) that Ohio law is applicable. Under the circumstances of this case, we believe the state of incorporation to be of no consequence, since it is universally recognized that a director owes a fiduciary duty to his corporation and to those interested in it. See *Pepper* v. *Litton,* 308 U.S. 295, 306; *Superintendent of Insurance* v. *Bankers Life and Casualty Co.,* No. 70–60, this Term, decided November 8, 1971. The Ohio cases cited by respondent (Br. in Opp. 3–4) stand only for the conceded proposition that directors must not act in bad faith with respect to shareholders. None of them suggests any objective test which could form the basis for an ascertainable standard. Indeed, in *Wilberding* v. *Miller,* 90 Ohio St. 28, 42, upon which respondent relies, the court observed that it "ought not to and would not intervene to control or change" a corporation's dividend policy "[i]n the absence of bad faith or an unreasonable exercise of * * * discretion." See also *Schuckman* v. *Rubenstein,* 164 F. 2d 952, 957 (C.A. 6).

bad faith. Were the rule otherwise, then any grant of discretion to a trustee would, in and of itself, serve to create such a standard. For, as the Second Circuit explained in *Stix* v. *Commissioner*, 152 F. 2d 562, 563, "no language [of a trust instrument granting discretion to a trustee], however strong, will entirely remove any power held in trust from the reach of a court of equity. After allowance has been made for every possible factor which could rationally enter into the trustee's decision, if it appears that he has utterly disregarded the interests of the beneficiary, the court will intervene. Indeed, were that not true, the power would not be held in trust at all; the language would be no more than a precatory admonition."

To be distinguished from the instant case are cases like *Jennings* v. *Smith*, 161 F. 2d 74 (C.A. 2), upon which the majority below relied (R. 44, 45). The trustees there, of whom the grantor was one, had the power in their absolute discretion to distribute corpus if a beneficiary suffered prolonged illness or extraordinary financial misfortune, and to distribute current income if necessary to maintain a beneficiary's station in life. The Second Circuit held (161 F. 2d at 77) that "the trust instrument provided an external standard which a court of equity would apply to compel compliance by the trustees on the happening of the specified contingency or to restrain threatened action if the condition were not fulfilled." It concluded, therefore (*id.* at 78), that the conditions imposed on the exercise of the grantor's right to shift the enjoyment of the trust property and income "effectively put that

'right' beyond his own control." This Court's opinion in *Sunnen* forecloses a similar conclusion in the instant case.[8]

Sunnen's teaching is relevant here in still another respect. The Court found in that case (333 U.S. at 609) that "[t]he taxpayer's controlling position in the corporation also permitted him to regulate the amount of royalties payable to his wife." Since the contracts neither provided for minimum royalties, nor required the corporation to manufacture a minimum number of the patented articles, the taxpayer could, by controlling production and sales, increase or decrease the royalties, or eliminate them entirely by halting production. Decedent here had the same power to regulate the amount of dividends that would be paid to the trust through his control over corporate decisions generally and over dividend policy.

The majority of the court of appeals thought that decedent was in a position analogous to that of a grantor who had retained broad managerial powers over a trust, and cited *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339, for the proposition that the grantor's retention of such powers, including the right to veto sales of trust assets, does not require inclusion

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[8] In *United States* v. *Gates*, 376 F. 2d 65, the Tenth Circuit assumed that so long as the directors of a corporation did not violate their fiduciary duty in exercising their discretion with regard to dividend policy, they could not shift the beneficial enjoyment of the income from the corporation's stock. This assumption is erroneous, and is directly inconsistent with this Court's reasoning in *Sunnen*. At all events, *Gates* is distinguishable because the trustees in that case had the power to dispose of the stock, and presumably would have done so if the current return proved unsatisfactory.

of the trust property in his gross estate (R. 45). Insofar as the issue in that case may have turned on managerial powers, it is enough to point out that it arose prior to the enactment in 1924 of the predecessor of the present Section 2038 (see *Helvering* v. *City Bank Co.*, 296 U.S. 85, 89–90), and under the statute in force prior to the decision in *May* v. *Heiner*, 281 U.S. 238, which was thereafter completely recast by Congress into the predecessor of the present Section 2036 (see *Commissioner* v. *Estate of Church*, 335 U.S. 632, 639–640).

Moreover, the general proposition concerning managerial powers has no bearing where, as here, decedent's retained powers enabled him to regulate the flow of income to the trust.[9] This is not a case in which the grantor was required as trustee to treat the current beneficiaries and remaindermen of the trust impartially. He was not trustee, and the general rule requiring impartiality (see III Scott on *Trusts*, §236.11 (3d ed., 1967)) therefore has no application. In short, there is no analogy to the typical situation

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[9] *Beckwith* v. *Commissioner*, 55 T.C. 242, acquiescence, 1971–9 Int. Rev. Bull. 6, is not inconsistent with our position in this case. The grantor in *Beckwith* received proxies annually, and voted the stock he had transferred in trust, but he had no *retained* right to vote the controlling stock interest or to keep the trustees from selling the stock. In fact, it may be inferred from the opinion in *Beckwith* that the Tax Court would decide a case like the instant one in the government's favor. Among the authorities cited with approval by the court below (R. 44) in connection with its discussion of decedent's retained veto power was *Hays' Estate* v. *Commissioner*, 181 F. 2d 169 (C.A. 5). This Court, however, disapproved of the Fifth Circuit's decision in *Hays' Estate* in *Lober* v. *United States*, 346 U.S. 335, 336.

in which a trustee's broad powers to manage trust assets are subject to the restraint that he act in such a manner as to protect current beneficiaries as well as remaindermen. Decedent owed a fiduciary obligation only as a director, and, as we have shown, that obligation did not establish an objective limitation on his power to designate. Indeed, in the proper exercise of his discretion as a director, decedent may well have determined not to declare dividends even if the current beneficiaries were in need of additional income. And, with his absolute power to veto sales of trust assets, he could have prevented the trustee from selling the stock and reinvesting the proceeds in securities that would produce a greater current return.[10]

In sum, here as in *Sunnen* (333 U.S. at 608), decedent's retention of powers "may properly be said to have left him with something more than a memory." The corporation-trust device employed here provided two levels of discretion with regard to current distributions of income, and through the exercise of decedent's nearly absolute discretion at the first level, the trustee's discretion to distribute or accumulate income was dependent in the first instance upon the will and judgment of decedent. To hold in these circumstances

[10] Respondent points to the fact (Br. in Opp. 4) that the trustee, "in [its] sole discretion," could have distributed income from other income-producing trust assets. This fact is irrelevant to the issue before this Court. The Commissioner at no time has contended that the value of other trust assets is includible in decedent's gross estate, but has limited his contentions to the stock in question, because, with respect to it, decedent, as well as the trustee, had the power to designate.

that decedent's retention of powers does not require inclusion of the stock in his gross estate would flout the purpose of Section 2036(a)(2) to prevent transfers akin to testamentary dispositions from escaping taxation. Cf. Rev. Rul. 67-54, 1967-1 Cum. Bull. 269.

II. DECEDENT'S RETAINED VOTING CONTROL AND CONSEQUENT POWER TO DETERMINE ALL ASPECTS OF CORPORATE POLICY AFFORDED HIM THE RIGHT TO CONTINUED LIFETIME "ENJOYMENT" OF THE TRANSFERRED STOCK WITHIN THE MEANING OF SECTION 2036(a)(1)

A. DECEDENT'S VARIOUS RETAINED POWERS ARE TO BE CONSIDERED TOGETHER, NOT INDIVIDUALLY, IN DETERMINING WHETHER HE RETAINED THE RIGHT TO ENJOY THE TRANSFERRED STOCK

The purpose of Section 2036(a)(1), like that of Section 2036(a)(2), is to subject to the estate tax all gratuitous transfers which have the effect of testamentary dispositions. The former provision accordingly requires inclusion in the gross estate of property transferred in trust if the grantor retains for his lifetime the right to enjoyment of the property transferred. Consistently with the statutory purpose, which underlies Sections 2037 and 2038, as well as Section 2036, this Court has repeatedly held that the terms "enjoyment" and "enjoy" as used in those provisions and in their predecessors, "are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates." *Commissioner* v. *Estate of Holmes,* 326 U.S 480, 486. See *Helvering* v. *Hallock,* 309 U.S. 106, 114, 117-119; *Commissioner* v. *Estate of Church,* 335 U.S. 632, 645; *Lober* v. *United States,* 346 U.S. 335, 337; *United States* v. *Estate of Grace,* 395 U.S. 316, 320. The

statute thus applies not only where the rights or control over the property transferred is expressly reserved in the trust instrument, but also where the rights or control is retained as an incident to the transfer, Cf. *McNichol's Estate* v. *Commissioner*, 265 F. 2d 667 (C.A. 3), certiorari denied, 361 U.S. 829.

The Court's holdings require that, in determining whether decedent retained the enjoyment of the transferred stock, his retained powers to vote that stock and to veto any sales thereof be considered together, rather than in isolation from one another. These holdings also require that the significance of the retained powers with respect to the transferred stock be evaluated with due recognition of the fact of decedent's substantial stock holdings apart from the trust.

That was the approach taken by the Board of Tax Appeals and the Tax Court almost thirty years ago in *Estate of Holland* v. *Commissioner*, 47 B.T.A. 807, supplemental opinion, 1 T.C. 564. In that case, the decedent's retained voting control and power to prevent the transferee from selling the stock were deemed "on an inclusive view of the whole arrangement" (47 B.T.A. at 814; 1 T.C. at 565) to require the value of the stock to be included in her gross estate. While the decedent there retained an income interest as well, the supplemental opinion indicates that this factor was not necessary to support the decision. In contrast with the approach of the Board and the Tax Court, the majority of the court of appeals viewed each of decedent's retained powers in isolation from the other, and failed to appreciate the signifi-

cance of decedent's holdings of stock outside of the trust.

B. DECEDENT RETAINED THE MOST IMPORTANT BENEFITS ASSOCIATED WITH A CONTROLLING STOCK INTEREST IN A CLOSE CORPORATION

It is neither the mere retention of the right to vote the transferred stock, nor the veto power alone upon which the Commissioner relies to require inclusion of the stock in decedent's gross estate. Where a grantor's holdings of corporate stock (including transferred stock) represent only an unimportant minority interest, and are not significant from the standpoint of voting control, the reservation of either of such rights might well not require inclusion of the transferred shares under Section 2036(a)(1). But where the cumulative effect of the retained powers and the rights flowing from the shares not placed in trust leaves the grantor in control of a close corporation, and assures that control for his lifetime, he has retained the "enjoyment" of the transferred stock. This is vividly illustrated by the instant case, since, in several critical respects, decedent was in essentially the same position after the transfers as he had been previously. He had in fact retained those elements of the property interest which were important to him.

He retained the right to an executive position with the corporations, free from the possibility of discharge; he retained the right, within broad limitations, to fix his compensation and to receive liberal retirement and fringe benefits; he retained the right

to determine whether and when the corporations would be liquidated or merged into other corporations; and he retained the right to determine how long he would continue to enjoy these benefits through his veto power over the disposition of trust assets. These are the most important benefits associated with the controlling stock interest in a close corporation (see 1 O'Neal, *Close Corporations,* § 107 (1971 ed.); *McDaniel* v. *Painter,* 418 F. 2d 545, 548 (C.A. 10)), and thus constitute a "substantial present economic benefit" as that term has been used by this Court.[11]

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[11] In O'Neal, *supra,* the author describes the benefits of a controlling stock interest in a close corporation as follows:

> Unlike the typical shareholder in a publicly held corporation, who may be simply an investor or a speculator and cares nothing for the responsibilities of management, the shareholder in a close corporation is a co-owner of the business and wants the privileges and powers that go with ownership. His participation in that particular corporation is often his principal or sole source of income. As a matter of fact, providing employment for himself may have been the principal reason why he participated in organizing the corporation. He may or may not anticipate an ultimate profit from the sale of his interest, but he normally draws very little from the corporation as dividends. In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.
>
> Since a shareholder's principal income may depend on retention of a position in the company and since his business and social prestige may depend in part on the retention of a major officership, naturally he is anxious to assure himself permanent employment by the corporation (preferably as one of the major officers), free from the possibility of discharge by the directors or other share-

It is true that decedent did not retain all of his enjoyment of the transferred property. The trustee was given the right to receive such dividends as were declared by the boards of directors controlled by decedent, to receive liquidation distributions if decedent, as controlling stockholder, voted to liquidate one or more of the corporations, and to receive the proceeds of the sale of some or all of the stock if decedent authorized the sale. But it is not necessary for the application of Section 2036(a)(1) that all rights to enjoyment be retained. This was settled in 1949 when the Court declared in *Commissioner* v. *Estate of Church*, *supra* at 645, that a settlor could avoid tax under the "enjoyment" provisions only by a transfer in which he "absolutely, unequivocally, irrevocably, and without possible reservations, parts with * * * *all of his enjoyment of the transferred property*. After such a transfer has been made, the settlor must be left with * * * *no right* * * * *to enjoy the property* then or thereafter."[12] (Emphasis added.)

holders. In a publicly held corporation, power to control the corporation is relatively unimportant to the shareholder-investor; in a close corporation, the power to control corporate activities or at least to veto changes in directors, officers and employees and in the methods of operating the business may be vital to the shareholder-owner. * * *

[12] Respondent cites the *Church* case (Br. in Opp. 4) for the proposition that "[u]ndoubtedly, the most valuable property attribute of stocks is their income." The Court's statement in *Church* with reference to the corporate stocks there in question was (335 U.S. at 644) that "[p]robably their greatest property value to Church was his continuing right to get their income." That statement must of course be read in the context of the facts in *Church*, but, in any event, does not support the broad

More recently, in *United States* v. *Estate of Grace, supra* at 320, the Court reaffirmed its statement in *Church,* explaining that the purpose of the predecessor of Section 2036(a) "was to include in a decedent's gross estate transfers that are essentially testamentary—*i.e.,* transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime." See also *McNichol's Estate* v. *Commissioner, supra*; *Guynn* v. *United States,* 437 F. 2d 1148 (C.A. 4). The decision below cannot be squared with this purpose.

CONCLUSION

The judgment of the court of appeals should be reversed and the cause remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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assertion respondent makes. Still less does it bear meaningfully on the facts here, since the total dividends on the transferred stock from December, 1958, when the trust was created, until decedent's death in September, 1964, amounted to $303.50 (R. 25–26).

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